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TAGS: EFIN ECON PREL CH
SUBJECT: US-China Economic and Security Review Commission Discusses
Exchange Rate with China's Foreign Exchange Regulator

(U) This report is sensitive but unclassified. Please handle accordingly.

¶1. (SBU) Summary: On June 19, Wei Benhua, Deputy Administrator of China's State Administration of Foreign Exchange (SAFE), repeated to Chairman Larry Wortzel and Commissioner Patrick Mulloy of the U.S.-China Economic and Security Review Commission familiar arguments that China's currency now follows a managed float currency policy, that there is no consensus on whether China's currency is currently undervalued and that the U.S.-China deficit is not as large as the United States figures indicate. Chairman Wortzel and Commissioner Mulloy emphasized that the growing imbalances are unsustainable and that the U.S. Congress is growing impatient with China's slow progress on exchange rate reform. China's exchange rate policies are also leading to other distortions, including harming the ability of U.S. companies to export their goods from the United States to China. FinAtt pointed out that a more flexible exchange rate is in China's own interest and can help China manage its own economy better. End summary.

Congress Concerned

¶2. (SBU) Chairman Wortzel opened the discussion by emphasizing that China's slow pace of exchange rate reform has become an important bilateral political problem. While acknowledging that China has made progress, he urged China to allow its currency to have more flexibility to respond to market forces. He noted that Congress remains very concerned about the issue and that Senators Schumer and Graham, who visited China in March and are the sponsors of trade legislation aimed at China, are again calling for action. Commissioner Mulloy, commenting that he helped draft the legislation that requires Treasury to issue semi-annual reports to Congress on countries that manipulate their currencies, noted that the United States previously cited China in 1991. Although the Administration failed to cite China in its latest report, Mulloy added that China's export-led growth is widely viewed as unsustainable because of the imbalances it is producing.

Managed Float Policy

¶3. (SBU) Responding, Wei maintained that China's currency is based on market supply and demand, but is adjusted in

reference to a basket of currencies through a managed float arrangement. As for whether China's currency is undervalued, Wei insisted that there is no consensus on this point. When he served as China's Executive Director at the IMF (until 2003), Wei said he attended a number of meetings where this subject was debated but without reaching a conclusion. Wei argued that there is also disagreement on the size of the U.S.-China deficit. Although the United States calculated the deficit in 2005 to be over USD200 billion, he said according to Chinese statistics, the deficit was only USD114 billion. Moreover, nearly 60 percent of the profits from China's exports go to foreign-invested enterprises. Whatever the numbers, Wei said adjusting the exchange rate will do little to improve the trade deficit problem, although he asserted that relaxing U.S. restrictions on high-tech exports would make a big difference.

Other Countries Will Follow

¶4. (SBU) Referring to Wei's last point, Chairman Wortzel countered that high-tech export controls only represent 1.5 percent of the trade deficit, and as long as the currency is out of balance, this will have little consequence to the overall trade figures. Commissioner Mulloy warned that no matter how the deficit is measured, it is large and growing and could poison the bilateral political relationship. He pointed out that other Asian countries also have inflexible currency regimes and suggested that if China led the way, these other countries would follow suit. Regarding the foreign-invested companies that benefit from exporting to the United States from China, Mulloy noted that the interests of such U.S. companies are not necessarily aligned with U.S. national interests. He added that by maintaining

an undervalued currency, China discourages U.S. companies from exporting from the United States and instead encourages them to relocate operations to China. He compared China's policy of using its dollar earnings to buttress government industries to that of GMAC offering loans to customers to buy GM cars. As a result of China's undervalued currency, distortions are appearing in both the Chinese and in the U.S. economies.

¶5. (SBU) Although he disagreed with their views, Wei thanked the Chairman and Commissioner for their frankness in discussing the exchange rate issue. Wei suggested that it is important to analyze the makeup of China's exports. As China is still a developing country, Wei contended that most of China's exports are for low-value, labor-intensive goods. However, Mulloy pointed out that USD45 billion of the bilateral deficit is in high tech goods.

In China's Own Interest

¶6. (SBU) As the meeting came to a close, FinAtt noted that an op-ed piece by Treasury Under Secretary Tim Adams will soon appear in several Chinese newspapers. In the article, U/S Adams will focus on how a more flexible exchange rate is in China's own interest. Referring to Premier Wen Jiabao's recent statement of concern over overheating problems, FinAtt noted that a more flexible exchange rate will help China manage its economy more effectively.

¶7. (U) This report was cleared by the delegation.

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